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October 2003

TELECOMMUNICATIONS

Issues Related to Competition and Subscriber Rates in the Cable Television Industry

GAO Accountability * Integrity * Reliability

GAO-04-8

October 2003

Highlights

Highlights of GAO-04-8, a report to Senator John McCain, Chairman, Committee on Commerce, Science, and Transportation, U S Senate

TELECOMMUNICATIONS

Issues Related to Competition and Subscriber Rates in the Cable Television Industry

Why GAO Did This Study

Over 70 million American households receive television service from a cable television operator. In recent years, rates for cable service have increased at a faster pace than the general rate of inflation. GAO agreed to (1) examine the impact of competition on cable rates and service, (2) assess the reliability of information contained in the Federal Communications Commission's (FCC) annual cable rate report, (3) examine the causes of recent cable rate increases, (4) assess the impact of ownership affiliations in the cable industry, (5) discuss why cable operators group networks into tiers, and (6) discuss options to address factors that could be contributing to cable rate increases.

What GAO Recommends

GAO recommends that the Chairman of the FCC

- take immediate steps to improve the cable rate survey and
- review the commission's process for maintaining the status of effective competition.

In commenting on GAO's report, FCC agreed to make changes to its annual cable rate survey, but FCC questioned, on a cost/benefit basis, the utility of revising its process to keep the status of effective competition up to date. GAO believes that FCC should examine whether cost-effective alternative processes could help provide the Congress with more accurate information.

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To view the full product, including the scope and methodology, click on the link above For more information, contact Mark Goldstein at (202) 512-2834 or goldsteinm@gao gov

What GAO Found

Competition leads to lower cable rates and improved quality. Competition from a wire-based company is limited to very few markets. However, where available, cable rates are substantially lower (by 15 percent) than in markets without this competition. Competition from direct broadcast satellite (DBS) companies is available nationwide, and the recent ability of these companies to provide local broadcast stations has enabled them to gain more customers. In markets where DBS companies provide local broadcast stations, cable operators improve the quality of their service.

FCC's cable rate report does not appear to provide a reliable source of information on the cost factors underlying cable rate increases or on the effects of competition GAO found that cable operators did not complete FCC's survey in a consistent manner, primarily because the survey lacked clear guidance In particular, GAO found that 84 of the 100 franchises it surveyed did not provide a complete or accurate accounting of their cost changes for the year. Also, GAO found that FCC does not initiate updates or revisions to its classification of competitive and noncompetitive areas Thus, FCC's classifications might not reflect current conditions

A variety of factors contribute to increasing cable rates. During the past 3 years, the cost of programming has increased considerably (at least 34 percent), driven by the high cost of original programming, among other things. Additionally, cable operators have invested large sums in upgraded infrastructures, which generally permit additional channels, digital service, and broadband Internet access

Some concerns exist that ownership affiliations might indirectly influence cable rates. Broadcasters and cable operators own many cable networks. GAO found that cable networks affiliated with these companies are more likely to be carried by cable operators than nonaffiliated networks. However, cable networks affiliated with broadcasters or cable operators do not receive higher license fees, which are payments from cable operators to networks, than nonaffiliated networks

Technological, economic, and contractual factors explain the practice of grouping networks into tiers, thereby limiting the flexibility that subscribers have to choose only the networks that they want to receive. An à la carte approach would facilitate more subscriber choice but require additional technology and customer service. Additionally, cable networks could lose advertising revenue. As a result, some subscribers' bills might decline but others might increase.

Certain options for addressing cable rates have been put forth. Although reregulation of cable rates is one option, promoting competition could influence cable rates through the market process. Policies to bring about lower cable rates could have other effects that would need to be considered.

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Abbreviations

ACA	American Cable Association
BLS	Bureau of Labor Statistics
CPI	consumer price index
DBS	direct broadcast satellite
FCC	Federal Communications Commission
LEC	local exchange carrier
MMDS	multichannel multipoint distribution service
MSA	metropolitan statistical area
MSO	multiple system operator
NATOA	National Association of Telecommunications Officers and Advisors
NBC	National Broadcasting Company
NCTA	National Cable and Telecommunications Association
YES	Yankees Entertainment and Sports Network

United States General Accounting Office
Washington, DC 20548

October 24, 2003

The Honorable John McCain
Chairman, Committee on Commerce,
Science, and Transportation
United States Senate

Dear Mr. Chairman.

In recent years, cable television has become a major component of the American entertainment industry—today more than 70 million households receive their television service through a subscription to a cable television operator. As the industry has developed, it has been affected by regulatory and economic changes. Since 1992, the industry has undergone rate reregulation and then in 1999, partial deregulation. Additionally, competition to cable operators has emerged erratically. Companies emerged in some areas to challenge cable operators, only to halt expansion or discontinue service altogether. Conversely, competition from direct broadcast satellite (DBS) operators (such as DIRECTV and EchoStar)—which did not exist a decade ago—has emerged and grown rapidly in recent years. Nevertheless, cable rates continue to increase at a faster pace than the general rate of inflation.

You asked us to review several issues related to recent increases in cable rates and the competitiveness of the subscription video industry—an industry that includes cable television, satellite service (including DBS operators), and other technologies that deliver video services to customers' homes. We agreed to (1) examine the impact of competition in the subscription video industry on cable rates and service; (2) assess the reliability of the information contained in the Federal Communications Commission's (FCC) annual cable rate report on the cost factors underlying cable rate increases, FCC's current classification of cable franchises regarding whether they face effective competition, and FCC's related findings on the effect of competition; (3) examine the causes of recent cable rate increases; (4) assess whether ownership of cable networks (such as CNN and ESPN) may indirectly affect cable rates through such ownership's influence on cable network license fees or the carriage of cable networks; (5) discuss why cable operators group networks into tiers, rather than package networks so that customers can purchase only those networks they wish to receive; and (6) discuss options to address factors that could be contributing to cable rate increases.

To respond to the first objective on the impact of competition on cable rates and service, we used an empirical model (our cable-satellite model) that we previously developed that examines the effect of competition on cable rates and service.[1] Using data from 2001, the model considers the effect of various factors on cable rates, the number of cable subscribers, the number of channels that cable operators provide to subscribers, and DBS penetration rates for areas throughout the United States. We further developed the model to more explicitly examine whether varied forms of competition have differential effects on cable rates. We also discussed the degree and impact of competition in the subscription video industry with an array of industry stakeholders and experts (see below).

For the second objective on the reliability of data in FCC's annual cable rate report, we randomly sampled 100 of approximately 750 cable franchises that responded to FCC's 2002 cable rate survey.[2] We designed this sample to be representative of the universe of franchises that responded to FCC's survey. Using a telephone survey (our cable franchise survey), we asked these franchises a series of questions about how they completed a portion of FCC's survey that addresses cost factors underlying annual cable rate changes (see app. II). We also examined FCC's process for classifying cable franchises regarding whether they face *effective competition*, a term defined by statute (see app. III).

For the third, fourth, fifth, and sixth objectives addressing the causes of recent cable rate increases, the impact of ownership affiliations, why cable operators group networks into tiers, and possible options for addressing factors that may be contributing to rate increases, we interviewed officials and obtained documents and data from FCC and the Bureau of Labor Statistics. We also interviewed officials from several trade associations and other organizations: the National Cable and Telecommunications Association (NCTA), Consumers Union, the National Association of Broadcasters, the National Association of Telecommunications Officers and Advisors, the American Cable Association, the National Cable Television Cooperative, three major sports leagues, and the Cable Television Advertising Bureau. We also conducted semistructured

[1]See U S General Accounting Office, *Telecommunications Issues in Providing Cable and Satellite Television Service*, GAO-03-130 (Washington, D C Oct 15, 2002)

[2]Each year, FCC samples between 700 and 800 of the universe of roughly 10,000 cable systems using a stratified sampling approach that is based on the status of effective competition and the size of the cable system.

interviews with a variety of companies: 11 cable operators, one DBS operator, four broadcast networks (such as ABC and NBC), 15 cable networks (such as CNN and ESPN), and representatives of five financial analysis firms. Furthermore, we used data on cable network revenues and programming expenses that we acquired from Kagan World Media, which is a private communications research firm that specializes in cable industry data. We used these data to develop models that examine whether ownership of cable networks by broadcasters or by cable operators influences (1) the level of license fee (our cable license fee model) or (2) the likelihood that the network will be carried (our cable network carriage model).

We conducted our review from December 2002 through September 2003 in accordance with generally accepted government auditing standards. For additional information on our scope and methodology, see appendix I.

Results in Brief

Competition from wire-based and DBS operators leads to lower cable rates and improved quality and service among cable operators. Competition from a wire-based provider—that is, a competitor using a *wire* technology, such as a second cable operator, a local telephone company, or an electric utility—is limited to very few markets. However, in those markets where this competition is present, cable rates are significantly lower—by about 15 percent—than cable rates in similar markets without wire-based competition. Since 1999, when DBS operators acquired the legal right to provide local broadcast stations (such as affiliates of ABC, CBS, Fox, and NBC), these companies have emerged as important competitors to cable operators. In particular, in areas where subscribers can receive local broadcast stations from both primary DBS operators, the DBS penetration rate—that is, the percentage of households that subscribe to satellite service—is approximately 40 percent higher than in areas where subscribers cannot receive local broadcast stations from both primary DBS operators. In addition, the DBS provision of local broadcast stations has induced cable operators to improve the quality of their service by providing their subscribers with approximately 5 percent additional cable networks.

FCC's cable rate report may not provide reliable information on the factors underlying recent cable rate increases or on the effect of competition. In particular, cable franchises responding to FCC's 2002 survey did not complete in a consistent manner the section pertaining to the factors underlying cable rate increases primarily because of a lack of clear guidance, 73 of 100 cable franchises whom we spoke with said that the instructions included with FCC's survey were insufficient. These inconsistencies may have led to unreliable information in FCC's report on the relative importance of factors underlying recent cable rate increases. For example, we spoke with 83 franchises that reported zero for infrastructure investment to FCC, 33 of these franchises told us that they had incurred costs for such investments, thereby implying that they understated the contribution of infrastructure investment to their cable rate increases. Overall, we found that 84 of the 100 franchises we surveyed did not provide a complete or accurate accounting of their cost changes for the year. Regarding the effect of competition, because FCC's process does not provide for updates or revisions to the competitive classification of cable franchises unless specifically requested to do so, FCC's classifications of cable franchises as having (or not having) effective competition on the basis of the statutory definition do not always accurately reflect current competitive conditions. In our analysis of the impact of wire-based competition, we checked the current status of competition in each franchise. The changes we made as a result of this process may explain, in part, the differential findings regarding the impact of wire-based competition reported by FCC, which found a nearly 7 percent reduction in cable rates, and our finding of a 15 percent reduction in cable rates. Because the Congress and FCC use this information in their monitoring and oversight of the cable industry, the lack of reliable information in FCC's report on these two issues—factors underlying cable rate increases and the effect of competition—may compromise the ability of the Congress and FCC to fulfill these roles. Additionally, the potential for this information to be used in debate regarding important policy issues, such as media consolidation, also necessitates reliable information in FCC's report. To improve the quality and usefulness of the data FCC collects annually on cable television rates and competition in the subscription video industry, we recommend that the Chairman of FCC take steps to improve the reliability, consistency, and relevance of information on rates and competition in the subscription video industry.

Several key factors—including programming costs and infrastructure investments—are putting upward pressure on cable rates. Programming costs incurred by cable operators have risen considerably—on average by as much as 34 percent—in the last 3 years, and, in particular, programming costs associated with cable networks showing sporting events have risen even more—on average by 59 percent—during the same time frame. The cable industry has also spent billions of dollars in upgrading its infrastructure to enable new services, such as digital channels and broadband Internet access. While these upgrades benefit cable subscribers by expanding the number of cable networks available and improving picture quality, some of this benefit accrues to subscribers who purchase new, advanced services, such as broadband Internet access. Additionally, cable operators have increased spending on customer service, which typically is now available 24 hours a day, 7 days a week. For the 9 cable operators[3] that provided financial information to us, we found that programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years.[4]

Several industry representatives whom we spoke with believe that certain factors related to the nature of ownership affiliations may also indirectly influence cable rates through their influence on cable operators' choice of which cable networks to carry and the cost to the cable operator for the right to carry the networks. We did not find that ownership affiliations between cable networks (such as CNN and ESPN) and broadcasters (such as NBC and CBS) or between cable networks and cable operators (such as Time Warner and Cablevision) are associated with the level of license fees—that is, the fees cable operators pay to carry cable networks. However, we did find that both forms of ownership affiliations are associated with the likelihood that a cable operator would carry a cable network. Holding constant certain other factors that might influence the likelihood of a cable network being carried by a cable operator—such as the popularity of the network or the type of programming the network carries—we found that operators were more likely to carry cable networks that were majority-owned by either cable operators or by broadcasters than to carry other cable networks. Moreover, cable operators were substantially more likely to carry cable networks that they directly own than to carry cable networks owned by other cable operators, broadcasters, or others.

Currently, technological, contractual, and economic factors lead cable operators to sell large numbers of networks on tiers. On average, a basic tier of service includes about 25 channels, including local broadcast stations, and the next tier provides, on average, 36 additional channels, including such popular cable networks as CNN and ESPN. Because

[3]These 9 cable operators that provided data to us serve approximately 62 percent of all cable subscribers in the United States as of 2002.

[4]While programming expenses are directly related to the cable rates, it is less clear how much of the infrastructure investment underlies cable rate increases since some of these costs are more directly related to the provision of digital cable tiers and cable modem service

subscribers must buy *all* of the networks offered on a tier that they choose to purchase, they have little choice regarding the individual networks they receive. Greater subscriber choice might be provided if cable operators used an à la carte system, wherein subscribers would receive and pay for only the networks they want to watch. But, an à la carte system could impose additional costs on subscribers in the near term because additional equipment—which many subscribers do not currently have—will be required on every television attached to the cable system to unscramble networks the subscriber is authorized to receive. Moreover, an à la carte system could alter the current economics of the cable network industry, wherein cable networks derive significant revenues from advertising. In particular, cable networks experiencing a falloff in subscribers could also see an associated decline in advertising revenues, since the amount that companies are willing to pay for advertising spots is based on the number of potential viewers. Although cable networks may take steps to reduce their production costs to compensate for the decline in advertising revenue, cable networks may also raise the license fees charged to cable operators for the right to carry the networks. If license fees rise, some of the increase is likely to be passed on to subscribers. Because of the reliance on advertising revenues by the cable network industry, most cable networks require that cable operators place their networks on widely distributed tiers. A variety of factors—such as the pricing of à la carte service, consumers' purchasing patterns, and whether certain niche networks would cease to exist with à la carte service—make it difficult to ascertain how many consumers would be better off and how many would be made worse off under an à la carte approach. Creating a separate tier for sports channels may be viable because this genre of programming has a loyal base of customers. However, sports leagues may be reluctant to have sporting events appear on cable networks that are placed on a separate sports tier because the programming would not be widely available.

Certain options for addressing factors that may be contributing to cable rate increases have been put forth. Although reregulation of cable rates stands as a possible option, taking steps to promote competition would help to reduce cable rates by leveraging the normal workings of the marketplace. Specific options include reviewing whether modifications to the program access rules would be beneficial, promoting wireless competition, and reviewing whether changes to the retransmission consent process should be considered. Any options designed to help bring down cable rates could have other unintended effects that would need to be considered in conjunction with the benefits of the lower rates. We are not making any specific recommendations regarding the adoption of any of these options.

FCC provided comments on a draft of this report in which they stated that the agency is taking steps to redesign their survey questionnaire in an attempt to obtain more accurate information. However, FCC questioned, on a cost/benefit basis, the utility of adopting a revised process to keep the status of effective competition in franchises up to date. We believe that providing the Congress with reliable information on cable rates and competition is important, and that more accurate effective competition designations would help to accomplish this. Therefore, we believe that FCC should examine whether cost-effective alternative processes exist to enhance the accuracy of its effective competition designations. FCC's comments are contained in appendix VI, along with our responses to those comments. We also provided a draft of this report to several industry participants and other experts for their review and comment. The comments we received covered a broad range of issues and each groups' comments are summarized in appendix VII.

Background

Cable television emerged in the late 1940s to fill a need for television service in areas with poor over-the-air reception, such as mountainous or remote areas. By the late 1970s, cable operators began to compete more directly with free over-the-air television by providing new *cable networks*, such as HBO (introduced in 1972), Showtime (introduced in 1976), and ESPN (introduced in 1979). According to FCC, cable's penetration rate—as a percentage of television households—increased from 14 percent in 1975 to 24 percent in 1980 and to 67 percent today. Cable television is by far the largest segment of the subscription video market, a market that includes cable television, satellite service (including DBS operators such as DIRECTV and EchoStar), and other technologies that deliver video services to customers' homes.

To provide programming to their subscribers, cable operators (1) acquire the rights to carry cable networks from a variety of sources and (2) pay license fees—usually on a per-subscriber basis—for these rights. The three primary types of owners of cable networks are large media companies that also own major broadcast networks (such as Disney and Viacom), large cable operators (such as Time Warner and Cablevision), and independent programmers (such as Landmark Communications).

At the community level, cable operators obtain a franchise license under agreed-upon terms and conditions from a franchising authority, such as a township or county.[5] During cable's early years, franchising authorities regulated many aspects of cable television service, including franchise terms and conditions and subscriber rates. In 1984, the Congress passed the Cable Communications Policy Act, which imposed some limitations on franchising authorities' regulation of rates.[6] However, 8 years later, in response to increasing rates, the Congress passed the Cable Television Consumer Protection and Competition Act of 1992. The 1992 Act required FCC to establish regulations ensuring reasonable rates for *basic service*—the lowest level of cable service, which includes the local broadcast stations—unless a cable system has been found to be subject to *effective competition*, which the act defined.[7] The act also gave FCC the authority to regulate any unreasonable rates for upper tiers (often referred to as *expanded-basic service*), which include cable programming provided over and above that provided on the basic tier.[8] Expanded-basic service typically includes such popular cable networks as USA Network, ESPN, and CNN. In anticipation of growing competition from satellite and wire-based operators, the Telecommunications Act of 1996 phased out all regulation of expanded-basic service rates by March 31, 1999. However, franchising authorities can regulate the basic tier of cable service where there is no effective competition.

As required by the 1992 Act, FCC annually reports on average cable rates for operators found to be subject to effective competition compared with operators not subject to effective competition. To fulfill this mandate, FCC annually surveys a sample of cable franchises regarding their cable rates. In addition to asking questions that are necessary to gather information to provide its mandated reports, FCC also typically asks questions to help the agency better understand the cable industry. For example, the 2002 survey included questions about a range of cable issues, including the cost factors

[5]In some cases, state public service commissions are also involved in cable regulation

[6]The 1984 Act restricted regulation to only basic services for cable systems that were not subject to effective competition In its rulemaking, FCC initially said that effective competition existed if three or more over-the-air broadcast signals existed in a given market Under this definition, over 90 percent of all cable systems would be subject to effective competition and therefore not subject to rate regulation

[7]Under statutory definitions in the 1992 Act, substantially more cable operators would be subject to rate regulations than had previously been the case.

[8]Basic and expanded-basic are the most commonly subscribed to service tiers—bundles of networks grouped into a package—offered by cable operators. In addition, customers in many areas can purchase digital tiers and also premium pay channels, such as HBO and Showtime.

underlying changes in cable rates, the percentage of subscribers purchasing other services (such as broadband Internet access and telephone service), and the specifics of the programming channels offered on each tier.

Some franchise agreements were initially established on an exclusive basis, thereby preventing wire-based competition to the initial cable operator. In 1992, the Congress prohibited the awarding of exclusive franchises, and, in 1996, the Congress took steps to allow telephone companies and electric companies to enter the video market. Initially unveiled in 1994, DBS served about 18 million American households by June 2002. Today, two of the five largest subscription video service providers are DIRECTV and EchoStar—the two primary DBS operators.

Competition Leads to Lower Cable Rates and Improved Quality and Service among Cable Operators

Today, wire-based competition—that is, competition from a provider using a *wire* technology, such as a local telephone company or an electric utility—is limited to very few markets, with cable subscribers in about 2 percent of markets having the opportunity to choose between two or more wire-based video operators. However, in those markets where this competition is present, cable rates are significantly lower—by about 15 percent—than cable rates in similar markets without wire-based competition, according to our analysis of rates in 2001. DBS operators have emerged as a nationwide competitor to cable operators. This competition has been facilitated by the opportunity to provide local broadcast stations. Competition from DBS operators has induced cable operators to lower cable rates slightly, and DBS provision of local broadcast channels has induced cable operators to improve the quality of their service

Wire-Based Competition Is Limited but, Where Available, Has a Downward Impact on Cable Rates

Although the Telecommunications Act of 1996 sought to increase wire-based competition, few customers have a choice among companies providing video service via wire-based facilities. In a recent report, FCC noted that very few markets—about 2 percent—have been found to have effective competition based on the presence of a wire-based competitor.[9] Our interviews with 11 cable operators and five financial analysis firms

[9]See Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Ninth Annual Report*, FCC 02-338 (Washington, D C Dec. 31, 2002)

yielded a similar finding—wire-based competition is limited. Local telephone companies are not providing widespread competition to cable, and FCC also reported in their 2002 video competition report that the four largest local telephone companies have largely exited the cable market. Also, electric and gas utilities—which can use their networks and rights of way to provide video services—are only providing competition to cable operators in scattered localities. Broadband service providers—a relatively new kind of entrant, such as Knology and WideOpenWest—are building new, advanced networks to provide a bundle of services (video, voice, and high-speed Internet access) and compete with cable operators as well as with telephone companies. However, the three largest broadband service providers only serve approximately 940,000 subscribers.

Although wire-based competition is limited, in those markets where it exists, this competition has a measurable impact. According to our cable-satellite model (see app. IV), in 2001, cable rates were approximately 15 percent lower in areas where a wire-based competitor was present.[10] With an average monthly cable rate of approximately $34 that year, this implies that subscribers in areas with a wire-based competitor had monthly cable rates about $5 lower, on average, than subscribers in similar areas without a wire-based competitor. Our interviews with cable operators also revealed that these companies generally lower rates and/or improve customer service where a wire-based competitor is present. For example, 1 cable operator told us that it stopped raising rates 3 years ago in one market where a wire-based competitor had entered.[11]

DBS Has Become an Important Competitor to Cable Operators Nationwide

In recent years, DBS has become the primary competitor to cable operators in the subscription video industry. As of June 2002, about 18 million households—roughly 20 percent of the total video subscribers—were served by DBS. Most cable operators that we interviewed described competition from DBS as substantial. The ability of DBS operators to compete against cable operators was bolstered in 1999 when they acquired the legal right to provide local broadcast stations—that is, to offer the

[10]Our model was based on data from 2001 since this was the most recent year for which we were able to acquire the required data on cable rates and services and DBS penetration rates when we began this analysis.

[11]This cable operator also noted that current rates in the market are not sustainable given the increasing cost of programming

signals of over-the-air broadcast stations, such as affiliates of ABC, CBS, Fox, and NBC—via satellite to their customers.[12] On the basis of our cable-satellite model, we found that in areas where subscribers can receive local broadcast stations from both primary DBS operators, the DBS penetration rate—that is, the percentage of housing units that have satellite service—is approximately 40 percent higher than in areas where subscribers cannot receive these stations from the DBS operators. In a recent report, FCC noted that in 62 of the 210 television markets in the United States, at least one DBS operator offered local broadcast stations.[13] Both EchoStar and DIRECTV continue to roll out the provision of local broadcast stations in more markets.

DBS competition is associated with a slight reduction in cable rates as well as improved quality and service. In terms of rates, we found that a 10 percent higher DBS penetration rate in a franchise area is associated with a slight rate reduction—about 15 cents per month.[14] Also, in areas where both primary DBS operators provide local broadcast stations, we found that the cable operators offer subscribers approximately 5 percent more cable networks than cable operators in areas where this is not the case. These results indicate that cable operators are responding to DBS competition and the provision of local broadcast stations by lowering rates slightly and improving their quality. During our interviews with cable operators, most operators told us that they responded to DBS competition through one or more of the following strategies: focusing on customer service, providing bundles of services to subscribers, and lowering prices and providing discounts.

[12]In 1999, the Congress passed the Satellite Home Viewer Improvement Act, which allows satellite operators to provide local broadcast stations to their customers. Prior to this act, satellite operators were limited to providing local broadcast signals to *unserved areas* where customers could not receive sufficiently high-quality, over-the-air signals This practice had the general effect of preventing satellite operators from providing local broadcast stations directly to customers in most circumstances.

[13]See *Ninth Annual Report*, FCC 02-338

[14]In our October 2002 report (GAO-03-130), we did not find that DBS competition was associated with lower cable rates. Although the parameter estimate was negative—indicating that DBS competition was associated with lower cable rates—the estimate was not statistically significant. As part of our analysis for this report, we further examined and refined our competition measures to more accurately reflect the true nature of competition in the franchise areas that were included in our analysis. Although the parameter estimate remains negative and the estimate is now statistically significant, the magnitude of estimate is very small.

Concerns Exist about the Reliability of FCC's Data for Cable Operator Cost Factors and Effective Competition

Responses to our cable franchise survey suggest that certain issues undermine the reliability of information in FCC's cable rate report, which provides information on cable rates and competition in the subscription video industry. In particular, we found that respondents did not fill out FCC's survey on factors underlying cable rate increases in a consistent manner. Additionally, FCC's designations of franchise areas as having (or not having) effective competition do not always accurately reflect current competitive conditions. For determinations of effective competition that are based on DBS service, local franchising authorities have raised concerns about the industry data used to substantiate these filings. Because the Congress and FCC use this information in their monitoring and oversight of the cable industry, the lack of reliable information in FCC's cable rate report may compromise the ability of the Congress and FCC to fulfill these roles. Additionally, the potential for this information to be used in debates on important policy decisions, such as media consolidation, also necessitates reliable information in FCC's report.

Weaknesses in FCC's Survey May Lead to Inaccuracies in the Relative Importance of Cost Factors

Results of our cable franchise survey indicated considerable variation in how cable franchises completed the section of FCC's 2002 cable rate survey on which they provide information about the factors underlying recent cable rate increases. Figure 1 shows the actual section of FCC's survey that franchises completed to provide their cost change information; see also appendix II for our cable franchise survey. We identified two key problems with FCC's survey, as follows: a lack of guidance on how the survey was to be completed, and the requirement that the sum of the cost and noncost factors equal the change in cable rates.

Figure 1: Section of FCC's 2002 Cable Rate Survey Covering Cable Franchises' Rate and Cost Changes

E Programming Service Charges in Community

In the following, the "basic cable service tier" or **BST** is the service tier that includes the retransmission of over-the-air broadcast signals and may include a few satellite or regional channels A "cable programming service tier" or **CPST** is any other tier containing programming other than that on the BST, pay-per-channel, or pay-per-view **CPST1** refers to the major CPST and typically meets two criteria It has the most channels and most subscribers among the CPST tiers (if more than one CPST is offered) Sometimes a "mini-tier" with considerably fewer channels has the most subscribers among the CPSTs This mini-tier is considered **CPST2**, whether or not it has the most subscribers

	Monthly Charges for Programming Services	July 1, 2000	July 1, 2001	July 1, 2002
48	Monthly charge for **BST**			
49	Monthly charge for **CPST1**			
50	Monthly charge for **BST plus CPST1** (rows 48 + 49)	$0.00	$0 00	$0.00
51	Year-to-date change in monthly charge on row 50	—	$0 00	$0.00

For July 1, 2001 and July 1, 2002, allocate the change shown on row 51 by estimating the dollars and cents that each factor, below, contributed The total of these factors (row 58) should equal the change on row 51

52	License or copyright fees, *existing* programs	—		
53	License or copyright fees, *new* programs	—		
54	Headend or distribution facility investment	—		
55	General inflation, not included elsewhere	—		
56	Other cost changes (positive or negative)	—		
57	Non-cost-related factors (positive or negative)	—		
58	Total of rows 52-57 (must equal row 51)	—	$0.00	$0.00

Source 2002 FCC cable rate survey

Our telephone survey with 100 cable franchises indicated that a lack of specific guidance regarding this cost change section of the survey caused considerable confusion about how to complete the form.[15] Every franchise that we surveyed said it was unclear what FCC expected for at least one of the six factors (five cost factors plus a noncost factor) listed in figure 1 above, and 73 of the 100 franchises said that the instructions were insufficient. In particular, several cable representatives we surveyed noted that there were no instructions or examples to show how to calculate investment, what types of cost elements should go into the "other cost" category, and what FCC meant by "non-cost-related factors." This lack of guidance created considerable variation in the approaches taken to develop the cost factors. For example, although 76 of the franchises left the noncost factors answer blank, other franchises included a number to

[15]See U S General Accounting Office, *Telecommunications: Data Gathering Weaknesses In FCC's Survey of Information on Factors Underlying Cable Rate Changes*, GAO-03-742T (Washington, D C May 6, 2003), page 7, for a summary of the approaches used by cable operators to complete the form

reflect a change in profit margin or the need to establish uniform rates across franchises.

Our cable franchise survey also indicated that another source of confusion for respondents was the requirement that the sum of the underlying cost and noncost factors (see fig. 1, lines 52-57) equal the change in the franchise's cable rates (see fig. 1, line 51). Because the expanded-basic service was deregulated in 1999, it is no longer necessary that the cost factors equal the yearly change in cable rates.[16] FCC officials told us that, cable operators could use the noncost factor element to adjust the sum of the factors to ensure that they equal the change in annual rates. That is, FCC officials suggested that after accounting for all cost factors, any difference between the sum of these costs and the rate change—whether positive or negative—could be accounted for by the noncost factor. However, it appears that this information may not have been clearly communicated to the cable franchises. We found that only 10 of the 100 franchises that we surveyed took this approach and instead, most franchises told us that they chose to change their estimate of one or more of the cost factors in order to achieve the rate-cost balance. In most cases, cable representatives told us that this meant reducing other cost factors because most franchises told us that their actual annual cost increases for the year covered by the 2002 survey exceeded their rate change for expanded basic service.[17] In fact, most franchises—84 of the 100 franchises we surveyed—did not provide a complete or accurate accounting of their cost changes for the year.[18]

According to FCC's 2002 cable rate report, cable franchises attributed 65 percent of their rate increases last year to the changes in the cost of new and existing programming. Comparatively, investment and other cost changes had a lesser role in the rate increases. However, our findings regarding how cable franchises responded to FCC's survey on these issues

[16]In unregulated markets, for example, costs are an important factor in price setting by companies, but several other key factors, such as consumer demand and the competitiveness of the market, also influence the market price. Thus, costs and prices need not move in tandem

[17]Many cable franchises we surveyed said that their profit margins for basic and expanded-basic cable services decreased in 2002, but many also said that those decreases were offset by increased profits from other services, such as cable Internet and digital cable

[18]For example, 15 cable franchises said that they entered dollar values in the factors until the entire rate increase was justified and did not consider the remaining cost factors, many others cited specific cost factors that were adjusted to reach a balance

indicated that the survey findings may not accurately reflect the relative importance of these cost factors. In particular, we found that most franchises used real cost data to calculate the change in new or existing programming costs. However, franchises often understated their estimates for investments and other costs. For example, 33 of the 83 respondents who entered zero for infrastructure investment, noted in our survey discussions with them that there had been costs for such investments that year. Similarly, we found that 64 franchises entered a zero for the other cost category, even though half of these respondents told us during our survey that there were costs in that category during that year. Moreover, the investment and other cost factors were often used to adjust overall costs to equal the rate change for the year—these adjustments most often required downward adjustments in these cost factors. As such, an overall accurate picture of the relative importance of various cost factors, which may be important for FCC and congressional oversight, may not be reflected in FCC's data.

FCC's Cable Rate Report Does Not Appear to Provide a Reliable Source of Information on the Effect of Competition

FCC is required by statute to produce an annual report on the differences between average cable rates in areas that FCC has found to have *effective competition* compared with those that have not had such a finding. FCC reported that on July 1, 2001, competitive operators were charging an average monthly rate of $34.93, while noncompetitive operators were charging $37.13—a 6.3 percent differential for the combined basic and expanded-basic tiers of service and equipment.[19] In another analysis, FCC looked at a subset of those areas that had been found to have effective competition—that is, areas in which effective competition had been granted on the basis of the existence of a wire-based competitor. Using a regression model, FCC found that cable rates were nearly 7 percent lower when such a competitor existed. Conversely, as previously mentioned, we found a greater impact of wire-based competition using a similar model, that is, rates were lower by 15 percent in locations where a wire-based competitor was operating, according to our cable-satellite model.

One possible explanation for the difference between FCC's results and those of our cable-satellite model may be the differences in the criteria used to classify the status of competition. When reporting on differences

[19]See Federal Communications Commission, *Report on Cable Industry Prices* (Washington, D.C. Apr. 1, 2002). This is the most recent FCC report that is consistent with the data used in our analysis.

between average rates for locations with and without effective competition, FCC is mandated to include in the group defined to have effective competition only those franchise areas that have had a finding by FCC that is based on the *statutory* definition of effective competition.[20] However, FCC's process for implementing this mandate may lead to situations in which the effective competition designation does not reflect the actual state of competition in the current time frame. In particular, key aspects of FCC's process are as follows:

- As set forth in FCC's rules, cable franchises are presumed not to face effective competition.
- Cable operators can petition FCC for a finding of effective competition, which would prohibit the franchising authority from regulating the rates for basic-tier service.[21] If the cable franchise can show that at least one of the statutory criteria for effective competition is met, FCC classifies the cable franchise as facing effective competition.
- A franchising authority can file a petition for recertification to regulate rates for basic-tier service, if it believes that the conditions under which effective competition was granted no longer exist. If recertification is granted, the franchise will no longer be considered to have effective competition.

Our analysis of FCC's classification of cable franchises regarding effective competition revealed that FCC's process for maintaining this classification—namely, their reliance on external parties to file for

[20]The 1992 Act established three conditions for a finding of effective competition, and a fourth was added in the 1996 Act Specifically, a finding of effective competition in a franchise area requires that FCC has found one of the following conditions to exist fewer than 30 percent of the households in the franchise area subscribe to cable service (low-penetration test), at least two companies unaffiliated with each other offer comparable video programming service (through a wire or wireless (e g , DBS service)) to 50 percent or more of the households in the franchise area, and at least 15 percent of the households take service other than from the largest company (competitive provider test); the franchising authority offers video programming service to at least 50 percent of the households in the franchise area (municipal test), or a local telephone company or its affiliate (or any other company using the facilities of such a carrier or its affiliate) offers video programming, by means other than DBS, that is comparable to that offered by the cable provider in the franchise area (local exchange carrier (LEC) test) For the LEC test to be applicable, the telephone company and the cable provider must be unaffiliated.

[21]Without a finding of effective competition, the cable operator must also charge a uniform rate for cable services throughout the cable franchise.

changes in the classification—may lead to some classifications of the competitive status of franchises that do not reflect current conditions. Using data from FCC's 2002 cable rate survey, we conducted several tests to determine whether information contained in franchises' survey information—which was filed with FCC in mid-2002—was consistent with the classification of effective competition for the franchise in FCC's records. We found some discrepancies. We subsequently interviewed officials from local franchising authorities in a number of areas with seemingly inconsistent information to further investigate the nature of the discrepancies.

Of 86 franchises in FCC's 2002 survey classified as satisfying the low-penetration test[22] for effective competition, we found that 48 franchises reported current information to FCC that indicate, on the basis of our calculations, the penetration rate exceeded the 30 percent threshold.[23] We spoke with officials from three local franchising authorities in areas having a low-penetration classification and found the following: a Maryland franchise with a current penetration rate of 75 percent, a Virginia franchise with a penetration rate of 76 percent, and a California franchise with a penetration rate of 97 percent. In the aforementioned franchise areas, the local officials told us that they did not know why the franchise was classified as low penetration. However, our review of FCC filings found that the cable operators in those franchise areas had filed for and received an effective competition finding that was based on the low-penetration test in the years between 1994 and 1997. Because there had never been a petition by the franchise authority to be recertified to regulate basic cable rates, the franchise area remained designated as having low penetration.

Under the statute, local franchising authorities do not have the authority to regulate cable rates in franchises found to have effective competition. Therefore, a franchise should not simultaneously be listed as facing effective competition and having regulation of basic rates. Of 262 franchises in FCC's survey classified as facing effective competition, 40 also reported that the franchising authority regulated their basic service rates. For example, FCC survey data include one franchise each in three

[22]The low-penetration test of effective competition applies if fewer than 30 percent of the households in the franchise area subscribe to cable service.

[23]We calculated the penetration rate by dividing the number of franchise subscribers by the number of households in the franchise area, as reported by the cable operator to FCC

states—New Jersey, Kentucky, and California—that were identified as facing effective competition and also as subject to rate regulation. Officials from the franchising authorities in New Jersey and Kentucky told us that they indeed regulate the basic service tier, and that no competitor was present. The official in Kentucky said that the discrepancy could be the result of a wire-based competitor that was granted a franchise but has yet to enter the market due to a lawsuit filed by the incumbent cable operator attempting to block the competitor's entry. The official in New Jersey said there is no competition in the area and the discrepancy may be attributed to the fact that two cable operators hold franchise agreements in the community, but do not compete against each other because each serves a different area of the community. According to an official in the California franchise, the franchise is not regulated—implying that the cable operator incorrectly answered FCC's question. However, the official also told us that there is no competition in the area—that is, while two cable operators hold franchise agreements, they do not compete against each other. We also found one franchise each in two states—Texas and Illinois—that were identified as facing effective competition and also reporting that they are subject to rate regulation. The official in the Texas franchise said that the discrepancy may be attributed to the fact that the incumbent cable operator filed for a finding of effective competition, but a finding has not yet been granted. According to a local franchising authority official in the Illinois franchise, the discrepancy could be a result of a wire-based competitor that expressed an interest in entering the market, but never did.

When the information contained in FCC's database on effective competition conflicts with a cable operator's response on the annual survey, FCC uses the information in their database for the purpose of its analysis of the differences in prices in areas with and without effective competition. We found that the survey responses on effective competition were not in accord with FCC's files for 24 percent of all franchises—or 165 franchises—in its 2002 survey.

DBS Subscriber Information Used in Effective Competition Filings Has Not Been Independently Validated

In the last several years, there have been dozens of petitions for a determination of effective competition based on DBS competition. However, the data on subscriber counts by zip code, which are used to make these petitions, are considered proprietary business information by DBS companies DBS providers EchoStar and DIRECTV, as well as big dish satellite provider Motorola, have agreed to make their individual market data available to SkyTRENDS—a market research and reporting firm for the satellite industry—which aggregates the information across the providers.[24] SkyTRENDS subsequently makes the aggregated data available to cable operators for the purpose of making filings for effective competition to FCC. Although FCC has not verified the SkyTRENDS data or the method used by SkyTRENDS (and by cable operators) to calculate penetration levels at the franchise level, it nonetheless accepts SkyTRENDS data for these petitions.

The SkyTRENDS data used to make effective competition petitions that are based on DBS competition are generally not available to government regulators. According to government regulators and a SkyTRENDS official, SkyTRENDS will not provide local franchising authorities with the underlying data used to support these filings, unless (in accordance with agreements with the satellite providers) the cable operator authorizes that dissemination. However, franchising authorities do have access to the data provided by cable franchises in their submissions for effective competition to FCC. According to FCC officials, the agency has not obtained detailed SkyTRENDS data since 1999. Some local franchise authorities have questioned the accuracy and validity of the DBS data and methods used by SkyTRENDS and cable operators for developing DBS penetration levels used to support effective competition determinations. Nevertheless, FCC has reiterated that it finds the SkyTRENDS data reliable for purposes of effective competition determinations, and that these data are the only available source for determining DBS penetration.

The Lack of Reliable Information May Compromise Monitoring and Oversight of the Cable Industry

FCC's annual cable rate report provides an important source of information about the cable industry. This report provides an extensive analysis of the cable industry, including such important factors as cable rates, factors underlying changes in cable rates, and provision of advanced services (such as cable modem Internet access). FCC's findings provide the Congress with information relevant to important policy decisions, including the regulation of cable rates and/or services and media consolidation and the convergence of video, voice, and data services. The lack of reliable information in FCC's cable rate report may compromise the ability of the Congress to make these important policy decisions and of FCC to monitor and provide oversight of the cable industry. As such, it is important for FCC's report to provide accurate, current, and relevant information about the cable industry.

[24] The provision of DBS data for effective competition has recently been transferred to the Satellite Broadcasting and Communications Association